SUPREME COURT, U. S.

Supreme Court, U.S.
FILED
SEP 1971

IN THE

Supreme Court of the United States

October Term, 1971

Docket No. 71-327

TEXAS GULF SULPHUR COMPANY, a Texas Corporation, CHARLES F. FOGARTY, RICHARD D. MOLLISON, ~~RICHARD H. CLAYTON, WALTER HOLYK, KENNETH H. DARKE, DAVID M. CRAWFORD,~~ CLAUDE O. STEPHENS, ~~EARL L. HUNTINGTON~~ and HAROLD B. KLINE,

Petitioners,

v.

SECURITIES AND EXCHANGE COMMISSION,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

ORISON S. MARDEN
14 Wall Street
New York, New York 10005
Attorney for Petitioners
Texas Gulf Sulphur Company,
Fogarty, Mollison, Stephens and Kline

P. B. KONRAD KNAKE
THOMAS MCGANNEY
JEFFREY A. BARIST
W. NEIL THOMAS, III
WHITE & CASE
Of Counsel

TABLE OF CONTENTS

	PAGE
Opinions Below	2
Jurisdiction	2
Questions Presented	2
With Respect to the Corporate Petitioner	2
With Respect to Individual Petitioners	4
With Respect to All Petitioners	5
Constitutional Provisions, Statutes and Rules Involved	5
Statement of the Case	6
A. Introductory Statement	6
B. The Charges Against Petitioners	7
C. The Facts as Developed at Trial	8
1. The Initial Drill Hole	8
2. The Subsequent Drilling	9
3. The Press Release of Sunday, April 12, 1964	10
D. The Decisions Below (The *First* Round)	11
1. Concerning the Individual Petitioners	11
2. Concerning Texas Gulf Sulphur Company	13
E. The Decisions Below (The *Second* Round)	15
1. The District Court	15
2. The Court of Appeals	17
Reasons for Allowance of the Writ	17

PAGE

Argument

I. This case raises fundamental and far reaching questions of administration of the securities laws and the proper roles of Congress, the Commission, and the federal courts 19

II. The holding below, which runs counter to a basic purpose of the securities laws, counter to the expressed intent of Congress and contrary to precedent, presents to this Court fundamental questions of importance under the securities laws concerning corporate and public information practices 22

III. The imposition of liability for negligent misstatement under Rule 10b-5 upon a well-intentioned company responding to false and exaggerated rumors and commenting on its affairs in the form of a press release presents to this Court an important question of freedom of speech 27

IV. The Second Circuit adopted a test of materiality in conflict with regulations adopted by the Commission, with decisions of the Seventh and Tenth Circuits, and with its own previous decisions 30

V. It is not unlawful for a corporate employee to purchase his company's stock or to accept stock options in the absence of a showing of fraud and deceit 33

VI. The Court of Appeals completely disregarded Rule 52(a) in (1) reaching geological, geophysical and investment conclusions which were contrary to findings of the trial court and without support in the record and (2) in implicitly overruling Judge Bonsal's finding that Texas Gulf officers had "exercised reasonable business judgment" (*i.e.*, acted with due diligence) in issuing the April 12 release 36

PAGE

VII. The decisions of the courts below violate petitioners' constitutional rights under the Fifth Amendment and well-settled principles of administrative procedure 38

VIII. Whether the SEC, in an enforcement proceeding under Section 21(e) of the 1934 Act, may seek a remedy which requires a stock option to be rescinded, is an issue as yet undecided by this Court and as to which a conflict exists between the Second and Ninth Circuits 40

IX. The Court below erroneously denied to petitioners an opportunity for oral argument of the issues before a quorum of the Court sitting *en banc* 41

Conclusion 42

Addendum ..... Add. 1

Appendix—(Opinions and Judgments of Court of Appeals and District Court, Separately Bound)

TABLE OF AUTHORITIES

PAGE

Cases:

Blau v. Lehman, 368 U.S. 403 (1962) 39
Blau v. Max Factor & Co., 342 F.2d 304 (9th Cir.), *cert. denied,* 382 U.S. 892 (1965) 34
Boyce Motor Lines, Inc. v. United States, 342 U.S. 337 (1952) 38

Cannon v. Texas Gulf Sulphur Co., 47 F.R.D. 60 (S.D. N.Y. 1969) 21

Graver Tank & Mfg. Co. Inc. v. Linde Air Prods. Co., 339 U.S. 605 (1950) 37
Greene v. Dietz, 247 F.2d 689 (2d Cir. 1957) 34

In re Calton Crescent, Inc., 173 F.2d 944 (2d Cir.), *aff'd sub nom.* Manufacturers Trust Co. v. Becker, 338 U.S. 304 (1949) 34

James Blackstone Memorial Library Ass'n. v. Gulf, M. & O. R.R., 264 F.2d 445 (7th Cir.), *cert. denied,* 361 U.S. 815 (1959) 31

List v. Fashion Park, Inc., 340 F.2d 457 (2d Cir.), *cert. denied sub nom.,* List v. Lerner, 382 U.S. 811 (1965) 31

McBoyle v. United States, 283 U.S. 25 (1931) 38
M. Kraus & Bros. Inc. v. United States, 327 U.S. 614 (1946) 38
Morris v. Burchard, 51 F.R.D. 530 (S.D.N.Y. 1971) 22

New York Times v. Sullivan, 376 U.S. 254 (1964) 29

Reynolds v. Texas Gulf Sulphur Co., CCH Fed. Sec. L. Rep. ¶93,019 (10th Cir. 1971) 6, 21
Rosenbloom v. Metromedia, 91 S. Ct. 1811 (1971) 29–30

PAGE

SEC v. Capital Gains Research Bureau, 375 U.S. 180 (1963) 21
SEC v. National Securities, Inc., 393 U.S. 453 (1969) 41
Sunray DX Oil Co. v. Helmerich & Payne, Inc., 398 F.2d 447 (10th Cir. 1968) 26n, 32

Thornhill v. Alabama, 310 U.S. 88 (1940) 29

United States v. Parkinson, 240 F.2d 918 (1956) 41

Constitutional Provisions, Statutes and Rules:

Federal Rule of Civil Procedure 23 21

Federal Rule of Civil Procedure 52(a) 13, 14, 19, 36, 37

First Amendment to the Constitution of the United States 18, 29, 30

Fifth Amendment to the Constitution of the United States 38

Investment Company Act of 1940 (15 U.S.C. §80a-1) 30n

Securities Act of 1933 (15 U.S.C. §77a, *et seq.*):

Section 17 .....20, 23

Securities Exchange Act of 1934 (15 U.S.C. §78, *et seq.*):

Section 9 22
Section 10(a) 22
Section 10(b) .....*passim*
Section 12 24
Section 14 24
Section 16 .....25, 34
Section 18 25
Section 21(e) 8, 40, 41
Section 27 ..... 8, 40
Section 32 .....25, 41

PAGE

SEC Rules and Regulations:

Regulation C, Rule 405 (17 C.F.R. §230.405(1)) 30n
Regulation S-X, Rule 1-02(g) (17 C.F.R. §210.1-02(g)) 30n
Rule 8b-2 (17 C.F.R. §270.8b-2) 30n
Rule 10b-5 (17 C.F.R. §240.10b-5) ..... *passim*
Rule 10b-6 (17 C.F.R. §240.10b-6) 20
Rule 12b-2(j) (17 C.F.R. §240.12b-2(j)) 30n

Other Authorities:

BROMBERG, *Securities Law: Fraud*—SEC Rule 10b-5 31

Cohen, Milton, *"Truth in Securities" Revisited*, 79 Harv. L. Rev. 1340 (1966) 25

Freeman, 22 Bus. Law. 922 (1967) 23n

Hearings on H.R. 7852 and H.R. 8720 before The House Committee on Interstate and Foreign Commerce, 73d Cong., 2d Sess. (1934) 22, 33-34

Hearings on H.R. 4344, H.R. 5065 and H.R. 5832 before The House Committee on Interstate and Foreign Commerce, 77th Cong., 1st Sess. (1941) 34

H.R. Rep. No. 85, 73d Cong., 1st Sess. (1933) 25

H.R. Rep. No. 1383, 73d Cong., 2d Sess. (1934) 33

Item 8(A) (b), 1 CCH Fed. Sec. L. Rep. ¶7327 ..... 26n

Loss, *History of S.E.C. Legislative Programs and Suggestions for A Code*, 22 Bus. Law. 795 (1967) 20

Loss, *Securities Regulation* (1961) 20, 35

Note, *Impact of Class Actions on Rule 10b-5*, 38 U. Chi. L. Rev. (Winter, 1971) 21–22

SEC Petition for Rehearing, Greene v. Dietz, 247 F. 2d 689 (2d Cir. 1957), CCH Fed. Sec. L. Rep. ¶90,821 (1957) 34

SEC Sec. Exch. Act Rel. No. 3230 (May 21, 1942) 23n

IN THE

Supreme Court of the United States

October Term, 1971

Docket No. .....

TEXAS GULF SULPHUR COMPANY, a Texas Corporation, CHARLES F. FOGARTY, RICHARD D. MOLLISON, RICHARD H. CLAYTON, WALTER HOLYK, KENNETH H. DARKE, DAVID M. CRAWFORD, CLAUDE O. STEPHENS, EARL L. HUNTINGTON and HAROLD B. KLINE,

Petitioners,

v.

SECURITIES AND EXCHANGE COMMISSION,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

To the Honorable Warren E. Burger, Chief Justice, and the Honorable Associate Justices of the Supreme Court of the United States:

Your petitioners herein, Texas Gulf Sulphur Company, Charles F. Fogarty, Richard D. Mollison, Claude O. Stephens and Harold B. Kline, respectfully pray that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Second Circuit entered in this proceeding on December 9, 1968 and June 10, 1971.

Opinions Below

The six opinions filed in 1968 by the Court of Appeals, *en banc,* are reported at 401 F.2d 833 and at p. 66a*; the 1971 opinion, not yet officially reported, appears at p. 220a. The first opinion of the District Court for the Southern District of New York (Bonsal, J.) is found at 258 F.Supp. 262 (1a) and the second opinion, after remand by the Court of Appeals, is found at 312 F.Supp. 77 (175a).

Jurisdiction

The judgments of the Court of Appeals for the Second Circuit were entered on December 9, 1968 and June 10, 1971, respectively, and this petition for certiorari was filed within ninety days of the latter date. This Court's jurisdiction is invoked under 28 U.S.C. §1254(1).

Questions Presented

With Respect to the Corporate Petitioner:

1. Whether Rule 10b-5, promulgated by the SEC under Sec. 10(b) of the Securities Exchange Act of 1934 (prohibiting the employment of "Manipulative and Deceptive Devices" in the purchase or sale of securities), is a valid basis for constructing, through the judicial process, a code of federal common law governing corporate information practices, swallowing up specific statutes in the securities laws regulating this subject, and in particular:

(a) Whether a press release, issued by a corporation in response to false and exaggerated rumors

* References in this form are to the separately bound Appendix to this petition.

regarding its operations, was issued "in connection with" the purchase or sale of securities (and thus within the alleged ambit of Rule 10b-5), when neither the corporation nor the draftsmen of the release were in the market to buy or sell the corporation's securities or attempting to influence the market;

(b) Whether Rule 10b-5 imposes an affirmative duty upon a corporation, speaking voluntarily and with laudable motives with respect to its exploration activities, to set forth all "basic facts" known to it, rather than to express the good faith judgment of its principal officers that no definite conclusions as to the importance of a prospect could be made until further drilling was completed, promising a second statement as soon as responsible conclusions could be drawn;

(c) Whether a finding of violation should be sustained without the slightest evidence that the corporation, or its principal officers, acted in bad faith or with knowledge of falsity, or recklessly, in drafting and issuing the press release;

(d) Whether, in an enforcement proceeding for injunctive relief, the standard for judging the character of a press release should be the subjective test of whether some persons read the release as suggesting that a sale of stock was advisable, rather than an objective appraisal by the equity judge of whether its phrasing was misleading in the light of the facts known to the draftsmen at the time of its issuance?

2. Whether freedom of speech has been abridged by a holding that a corporation, in commenting on matters of public importance with respect to its operations, may vio-

late Rule 10b-5 if it allegedly speaks negligently, even when the evidence shows that the release was issued in good faith, for a laudable purpose, and was not designed to bring economic or commercial benefit to either the corporation or the draftsmen?

With Respect to the Individual Petitioners:

3. Whether Section 10(b) and Rule 10b-5, which prohibit fraudulent practices in connection with the purchase or sale of securities, forbid investment in corporate securities by corporate personnel through the facilities of a national securities exchange when such personnel possess unpublished information which would not be significant to the average prudent investor and would not have a substantial impact on the market price of the securities?

4. Whether information should be deemed "material" within the meaning of Rule 10b-5 if it "may" affect the desire of "speculators and chartists of Wall and Bay Streets" to buy, sell or hold corporate stock and "might" have an effect on the market price of the stock, even though the information would not be "material," as specifically defined in SEC regulations, in a prospectus or a registration statement, since it would not be significant to the average prudent investor and would not have a substantial impact on the market price?

5. Whether Section 10(b) and Rule 10b-5 impose a duty upon recipients of stock options, granted without inducement on their part, to relate to a corporate Board of Directors or Stock Option Committee, without its request or expectation, information concerning the company, even though such information would not be significant to the

average prudent investor and would not have a substantial impact on the market price of the company's stock?

6. Whether the SEC, under its statutory authority to seek injunctions in the federal courts, may obtain remedies in the form of monetary forfeitures?

With Respect to All Petitioners:

7. Whether it was error for the Court of Appeals to disregard Rule 52(a) in (1) reaching geological and geophysical conclusions as to the significance of the exploratory drilling which were contrary to findings of the trial court and (2) implicitly overruling Judge Bonsal's finding that the Texas Gulf officers had exercised reasonable business judgment (*i.e.* due diligence) in issuing the release?

8. Whether Rule 10b-5, as construed and applied below, gave "fair warning" to petitioners that their conduct would be held unlawful, as required by the Fifth Amendment to the United States Constitution and basic principles of administrative procedure?

9. Whether the court below properly denied to petitioners an opportunity for oral argument of the issues before a quorum of the court sitting *en banc* in 1968?

Constitutional Provisions, Statutes and Rules Involved

Constitution of the United States, Amendment I and Amendment V, are set forth at page 235a of Appendix B.

48 Stat. 891, 899, 902, 904; 15 U.S.C. §§78j(b), 78u(e), 78aa, 78ff, are set forth at pp. 235a to 238a of Appendix B.

17 C.F.R. §§240.10b-5 and 240.12b-2(j) are set forth at pp. 238a and 239a of Appendix B.

Statement of the Case

A. Introductory Statement

This is a case of seminal importance* in the interpretation of the federal securities laws and in the development of what has been termed "a federal common law of corporations" under Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 promulgated thereunder. Indeed, the SEC, in opposing at an earlier stage the grant of certiorari with respect to two petitioning individual defendants, acknowledged the wide reaching significance of the case. (Brief for the Securities and Exchange Commission in Opposition to Petition for a Writ of Certiorari, in Nos. 897 and 937 (October Term, 1968), p. 25 (No. 897) and p. 23 (No. 937).) The decisions below are now substantially final and all aspects of this celebrated case are ripe for review.**

In addition, the companion petition† of Texas Gulf and Fogarty in *Mitchell* and *Reynolds* v. *Texas Gulf Sulphur Co.*, not yet officially reported (CCH Fed. Sec. L. Rep. ¶93,019 at 90,752 [10th Cir. 1971]), raise the further question of the standards governing private actions under Rule 10b-5; the decisions in that Tenth Circuit case, based on the initial decision of the Second Circuit herein, graphically

* Attached to this petition as an addendum is a partial bibliography indicating the widespread public concern over the issues now presented to this Court.

** Mr. Justice White, dissenting, was of the opinion that the issues presented by the petition filed by petitioner Kline in 1969 were sufficiently final to warrant review at that time (394 U.S. 976).

† The petition will be filed as soon as the Tenth Circuit has passed on a motion for rehearing filed by plaintiffs Mitchell and Reynolds on May 10, 1971.

demonstrate how the meaning and purpose of Rule 10b-5 have been expanded so as to supplant the limitations carefully imposed by Congress on private recovery under the securities laws, with results that run counter to the primary purpose of those laws.

B. The Charges Against Petitioners

Respondent instituted this action against petitioners and others on April 19, 1965, alleging *inter alia,* that petitioner Texas Gulf Sulphur Company (hereinafter "Texas Gulf") issued a press release on April 12, 1964 in response to rumors concerning its exploration for minerals in Canada, which was "known * * * to be materially false and misleading" in violation of Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. §78j(b), and of Rule 10b-5, 17 C.F.R. §240.10b-5 promulgated thereunder.

It was also alleged that petitioners Fogarty, Executive Vice President and a Director of Texas Gulf, and Mollison, Vice President, had purchased stock of Texas Gulf during the period from November 7, 1963 to just prior to April 12, 1964, while in possession of "material facts" concerning the result of "Texas Gulf's drilling" in the course of that exploration program, in violation of the same statute and rule. In addition, it was charged that Fogarty, Mollison, Stephens (President and a Director of Texas Gulf) and petitioner Kline, Vice President and General Counsel, had accepted stock options on February 20, 1964, in violation of the statute and rule because the members of the Stock Option Committee were unaware of the drilling results when the options were awarded.

Respondent sought an injunction under Section 21(e) of the 1934 Act against all defendants and additional relief which included rescission of the stock purchases and stock options by the individual defendants. Jurisdiction of the District Court was invoked under Section 27 of the 1934 Act, 15 U.S.C. §78aa. All parties waived a trial by jury and agreed that trial should first proceed on the question of violation alone.

C. The Facts as Developed at Trial

1. The Initial Drill Hole

In 1957, Texas Gulf initiated an exploration program in the geological area known as the Canadian Shield. Aerial geophysical surveys in 1959 over more than 15,000 miles indicated the presence of several hundred anomalies (areas of abnormal electrical conductivity) worthy of further investigation. On June 6, 1963, Texas Gulf acquired an option to purchase a 160 acre half lot near Timmins, Ontario, upon which one of the anomalies, known as Kidd-55, was thought in part to be located.

After conducting a ground geophysical survey, Texas Gulf proceeded with exploratory drilling. On November 8, 1963 the first drill hole (K-55-1) was begun near the corner of the lot Texas Gulf had acquired, and drilling of this 1⅛" diameter core was completed to a length of 655 feet on November 12, 1963. After examining this core, which contained encouraging showings of zinc and copper mineralization in varying amounts, Texas Gulf decided to try to acquire additional properties, since the core was drilled in a corner of the lot, and meanwhile to cease further drilling.

It was after this drill hole had been completed, and before further significant exploration had occurred, that petitioners Fogarty and Mollison purchased, respectively, 3100 and 300 shares of stock in Texas Gulf Sulphur Company. And before further drilling occurred, Texas Gulf's Stock Option Committee met at the call of its Chairman, who knew nothing about the drilling, and awarded qualified stock options to 26 officers and employees, including petitioners Stephens, Fogarty and Kline.

Stephens, Fogarty and Mollison were aware of the drilling results throughout this period. Kline, who was a lawyer and not a geologist, had only heard at a casual luncheon conversation that sulphides had been intersected near Timmins and that additional land acquisition would be attempted prior to further drilling.

2. *The Subsequent Drilling*

On March 31, 1964, Texas Gulf had sufficiently progressed with the acquisition of additional land to move more drill rigs into the area, and it resumed drilling. Between March 31 and 7:00 p.m. on April 9, drill cores had been obtained from two additional holes. The trial court concluded on the facts and the expert testimony that by April 9 at 7:00 p.m. "there was real evidence that a body of commercially mineable ore *might* exist" (28a-29a, emphasis supplied). However, the court also found that prior to this time the drilling results did not warrant such a conclusion (29a).

3. The Press Release of Sunday, April 12, 1964

The movement of four drill rigs to the site late in March and the commencing of additional drilling had generated rumors. These rumors intensified and on April 9, 1964, newspapers in Toronto reported discovery of "a major copper strike" and "one of the largest copper deposits in North America" (52a). On Saturday, April 11, both the *New York Times* and the *New York Herald Tribune* carried even more extravagant reports of Texas Gulf's drilling, describing it, *inter alia,* as "the biggest ore strike since gold was discovered more than 60 years ago in Canada" (52a). A quantity of false statistics appeared in the press, the company was accused of illegal conduct, and it was erroneously reported that a "penny stock" mining company was a partner with Texas Gulf in the exploration.

At this point, President Stephens, having consulted with the senior director of Texas Gulf, determined that Texas Gulf should issue a release to comment on the rumors. That release was drafted, on Stephens' instruction, by Fogarty after lengthy consultations on Saturday and Sunday with Mollison, who had been at Kidd-55 on Friday, April 10, and with Texas Gulf's public relations consultant. Before its release early Sunday afternoon it was cleared with a Texas Gulf attorney and read to President Stephens. The press release,* as issued, warned against accepting the extravagant rumors as fact, confirmed that Texas Gulf was drilling near Timmins, denied that it had a partner in the operation, stated that the drilling had "led to preliminary indications that more drilling would

* The press release is quoted in full in Judge Bonsal's second opinion (177a).

be required for proper evaluation of this prospect" (51a), and promised a further statement "when we have progressed to the point where reasonable and logical conclusions can be made" (51a).

D. The Decisions Below (The *First* Round)

1. Concerning the Individual Petitioners

During the four week trial, extensive evidence was introduced with respect to all aspects of the exploratory drilling and the significance of the first drill hole. This evidence included evaluations of geological and geophysical data, detailed logs of the drill hole, assay reports, examinations of the core itself, and testimony as to the significance of the drilling results to the value of Texas Gulf stock. In addition to Texas Gulf personnel, nine geologists, geophysicists or mining engineers and two security analysts testified. Numerous technical exhibits and demonstrative charts were considered by the trial judge.

On the evidence presented by both sides, the District Court concluded that "there is no way even to estimate the probabilities that one drill core will lead to the discovery of an ore body" (29a) and that therefore the results of the first drill core "were too 'remote' when considered in light of the size of TGS, the scope of its activities and the number of its outstanding shares [10,000,000], to have had any significant impact on the market, *i.e.*, to be deemed material" (30a). The District Court further found that "[t]he fact that subsequent drilling established a major ore body is immaterial" (33a). It thus held that the purchases by Fogarty and Mollison were not unlawful (34a).

For the same reasons, the District Court held that none of the petitioners was under a duty to disclose the preliminary drilling results to the Stock Option Committee (48a), and that none had violated Rule 10b-5 in accepting options from the company (49a). In addition, the District Court found that that Committee "relied on information furnished it by the higher echelons of TGS's management" (47a); and that it "did not inquire of the recipients what special knowledge they might have as to various phases of TGS's business as it was entitled to rely on the information furnished by the management" (47a). Mollison and Kline were held not to constitute "top management,"* and thus were under no duty to volunteer to the Stock Option Commitee information known to their superiors. As to Mr. Kline, the District Court held that he "knew no details" (48a), and unlike the other petitioners, did not know of the situation at Timmins as it existed at the time (49a).

The Second Circuit reversed the findings with respect to materiality. It substituted its own geological and geophysical conclusions, stating that the initial drill core indicated a "more than marginal" possibility of the existence of a mine of "vast magnitude" (89a). Departing from precedent and SEC regulations, it asserted that "material" facts are any "which may affect the desire of investors to buy, sell or hold the company's securities" (88a), and defined "investors" to include "the speculators and chartists of Wall and Bay Streets" (87a). The court concluded that the results of the first drill hole, if disclosed, "may" have affected the desires of such persons, and "might" have affected stock prices and, therefore, that the statute and rule prohibited all stock transactions by in-

* The SEC did not appeal this determination as to Mollison.

formed persons after the drilling of the first hole. It thus reversed, in disregard of Rule 52(a), the trial court's findings and held that Fogarty and Mollison had violated Rule 10b-5 by their stock purchases, and that Stephens, Fogarty and Kline were in violation because of their acceptance of stock options. As to Kline, the court reversed the finding that he was not a member of "top management," and held that he, too, had been under a duty to disclose the little he knew regarding the exploration before accepting an option. The case was remanded to the District Court for consideration of remedies.*

2. *Concerning Texas Gulf Sulphur Company*

Judge Bonsal concluded, first, that the press release had not been issued "in connection with the purchase or sale of any security" and, therefore, that Rule 10b-5 was not applicable (54a). In addition, on the basis of the extensive expert testimony and other evidence, the District Court concluded that the SEC had "failed to demonstrate that it [the April 12 press release] was false, misleading or deceptive" (54a). He apparently agreed with defendants' experts that the release "accurately set forth the situation as it was known at the time" (56a) and found that the procedures followed by Texas Gulf in preparing the release were in accord with "reasonable business judgment under the circumstances" (58a). Moreover, the District Court concluded:

---

* As to Kline, the Court of Appeals directed cancellation and rescission of his stock option. On the second appeal, it confessed its error in this respect and ordered a hearing on remedy to be held in the District Court (230a). The District Court, in a decision dated September 1, 1971, ordered Kline, in the event that he exercises his option, to pay over to Texas Gulf, in escrow subject to further order of the Court, the difference between the option price and the price of Texas Gulf stock on April 17, 1964.

> "it is apparent that the purpose of the April 12 press release was an attempt to meet the rumors which were circulating with respect to the Kidd 55 segment. There is no evidence that TGS derived any direct benefit from the issuance of the press release or that any of the defendants who participated in its preparation used it to their personal advantage. The issuance of the release produced no unusual market action." (54a)

The Court of Appeals reversed, again as we claim, in disregard of Rule 52(a), and announced an unprecedented rule of strict liability with respect to corporate press releases:

> "Rule 10b-5 is violated whenever assertions are made, as here, in a manner reasonably calculated to influence the investing public * * * if such assertions are false or misleading or are so incomplete as to mislead irrespective of whether the issuance of the release was motivated by corporate officials for ulterior purposes." (113a)

It further held that the District Court, by measuring the April 12 press release objectively, *i.e.*, against the geological, geophysical and investment conclusions of the expert witnesses, had applied the wrong standard; the case was remanded to the District Court for a new determination "applying the standard of whether the reasonable investor, in the exercise of due care, would have been misled by it" (115a). Should that issue be determined adversely to Texas Gulf, the District Court was instructed to determine "whether its issuance resulted from a lack of due diligence" (115a).

The Court of Appeals enunciated an *ex post facto* rule of corporate disclosure, *i.e.*, that a company, faced with extravagant and false rumors regarding its activities, must

not put out a preliminary "wait and see" statement, but should either obtain and publish all current reports of drilling, if possible, or delay publication of the release (116a-117a). Whatever the merits of this new rule, it had never before been enunciated or hinted at in the context of Rule 10b-5, which prohibits fraud and deceit in the purchase or sale of securities through the use of "manipulative or deceptive devices."

The majority opinion of Judge Waterman evoked strong dissent by two members of the Second Circuit (Chief Judge Lumbard and Judge Moore) and separate statements from four of the other judges. In his concurring opinion, Judge Friendly expressed his fears that the majority opinion would have serious repercussions. After noting that "no one has asserted, or reasonably could assert, that the purpose for issuing a release was anything but good" (121a), he went on to point out that if private damages were to be permitted in a case like this (as has subsequently happened), it could well result in the drying-up of corporate publicity (123a).

E. The Decisions Below (The *Second* Round)

1. The District Court

On remand, the District Court interpreted the Second Circuit's opinion with respect to the press release as calling for the application of a subjective test of investor reaction. Consequently, the remand proceeding consisted of a parade of investor witnesses, those called by the SEC dutifully reporting that they had been discouraged by the press release and sold because of it; those called by Texas Gulf testifying that they had found the release encouraging and had either bought or held Texas Gulf stock after read-

ing it. Judge Bonsal held that *both* sets of investors were "reasonable" (183a), but, following what he believed to be the mandate of the Second Circuit, he held that since *some* of those who had sold testified they were misled, the press release was misleading to at least those "reasonable investors" (184a). In addition, the court followed the implicit direction of the appellate court in finding that Texas Gulf had not exercised due diligence in drafting the release, but made no effort to reconcile this conclusion with its previous finding that reasonable business judgment, *i.e.*, due diligence, had been exercised. Thus the District Court held that Texas Gulf had violated Rule 10b-5, but, as there had been no showing of bad faith or of any likelihood of future violations, declined to issue an injunction.

Fogarty and Mollison had voluntarily turned back their stock and Fogarty and Stephens their stock options prior to the first trial, and the District Court held that there was no likelihood of future violations and that injunctive relief was inappropriate. In addition, the court pointed out that they could not have anticipated the extension of the scope of Rule 10b-5, and the rule of materiality in particular, which was later announced by the Second Circuit (196a). Similarly, the application of Rule 10b-5 to the grant of stock options had been novel and no injunctive relief against Stephens and Fogarty was required for that reason as well (211a).

As to Kline, Judge Bonsal felt bound by the mandate to rescind his stock option, but stated "that the remedy directed with respect to Kline merits reconsideration" by the Court of Appeals (213a). For the same reasons expressed as to Stephens and Fogarty, the SEC's application for an injunction was denied.

2. The Court of Appeals

On appeal, the Second Circuit approved the District Court's procedure of hearing a string of investor witnesses in order to determine whether the release was misleading to the reasonable investor, and it also approved the District Court's application of the subjective standard and the "due diligence" test in finding the press release in violation of Rule 10b-5. It further held that the finding of a violation without proof of *scienter* or economic benefit did not abridge the First Amendment, announcing that "the First Amendment deals with the free exchange of ideas and not with commercial 'factual' speech" (224a) and that the press release "is in the same category as corporate registration statements and prospectuses" (225a).

The decision below was in all other respects also affirmed, except that as to petitioner Kline, the court reversed its previous order directing cancellation of the stock option and remanded for further hearing. It affirmed, however, its previous finding that Kline had been in violation of Rule 10b-5, although the court admitted that the question was "an extremely close one factually" and that his violation was of a "borderline nature" (231a).

Reasons for Allowance of the Writ

1. This case marks the culmination of the development of a federal common law of corporations under Rule 10b-5. This development should be reviewed by this Court and limitations placed on the process by which the Rule has supplanted not only state law but specific statutory provisions adopted by Congress in the 1933 and 1934 Acts.

2. Dissemination of information concerning corporate affairs and activities is of great importance to the entire business community and the investing public. In this case the Second Circuit has devised rules governing voluntary disclosures which go far beyond the provisions of the 1934 Act and place impossible burdens of compliance on responsible corporate officials. This will inevitably result in curtailment of information to the public, in direct conflict with one of the basic purposes of the securities laws.

3. The First Amendment has been abridged by the holding that a press release with respect to matters of public interest, prepared for an admittedly laudable purpose and without commercial objective, violates Rule 10b-5.

4. Delineation of appropriate tests for determining whether a fact is "material" under the securities laws is fundamental to the proper administration of those laws. The tests adopted below establish an extremely low threshold of materiality, are hopelessly confusing to the business community and are in conflict with administrative regulations and judicial precedent.

5. The rules governing stock purchases (and receipt of stock options) by corporate employees are of great importance to the business community. Whether Rule 10b-5 is a proper vehicle for such regulation has not been but should be decided by this Court. The decisions below will chill investment by employees in the shares of their own companies and conflict with public policy encouraging such investment.

6. The Court of Appeals not only exceeded the permissible scope of appellate review by overturning and ignoring findings of fact by the trial court, but also made

crucial findings against the weight of the evidence, all contrary to Rule 52(a) F.R.Civ.P.

7. The duties imposed upon petitioners can neither be found in the language of Section 10(b) or Rule 10b-5 nor could they reasonably have been inferred. Petitioners had no fair warning that their conduct would be held illegal, as required by the Fifth Amendment, and as intended by the Administrative Procedure Act.

8. An administrative body empowered by statute to seek injunctions has here been allowed, in conflict with the Ninth Circuit, to obtain monetary penalties, utilizing the slight burden of proof which governs in a purely injunctive proceeding.

ARGUMENT

I

This case raises fundamental and far reaching questions of administration of the securities laws and the proper roles of Congress, the Commission, and the federal courts.

Stated in its broadest terms, the question presented to this Court for review involves the tendency of the lower federal courts, exemplified by the decisions of the Second Circuit herein (66a, 220a), to resolve more and more questions under the rather general language of Rule 10b-5 promulgated by a regulatory agency, rather than under applicable state law or the specific statutory provisions enacted by Congress. It concerns profound changes in substantive law, and the development of what has been termed

a "federal corporation law", under the guise of interpreting an administrative rule in the context of litigation.

Pursuant to statutory authority granted by Congress in §10(b) of the Exchange Act, the Commission has promulgated a series of regulations, most of which are precise and detailed, *e.g.*, Rule 10b-6, 17 C.F.R. §240.10b-6. In Rule 10b-5, however, the Commission adopted the general language of §17 of the Securities Act of 1933, 15 U.S.C. §77q. Instead of following sound principles of administrative law and promulgating comprehensible regulations concerning conduct of the nature attacked in this case, the Commission has proceeded to utilize the general clauses of Rule 10b-5 in a series of judicial contests to obtain revolutionary changes in corporate law with far reaching economic effects and social consequences. That process, culminating in this proceeding, has been compared to nineteenth century Germany's "flight into the general clauses," the tendency "to resolve more and more questions in terms of the handful of clauses in the Civil Code which are based on 'good faith' and similar clauses." 3 Loss, Securities Regulation, pp. 1789-90 (1961). Professor Loss has elsewhere stated, even prior to the Second Circuit's first decision in this case, that he has "become increasingly ashamed * * * at this sort of jurisprudence," continuing:

> "[D]o we have to go on indefinitely basing this whole revolutionary change on a section of the Exchange Act that says it shall be unlawful for any person in the purchase or sale of any security to engage in any act or practice that the S.E.C. prescribes (*sic*) as manipulative or deceptive? How big a house of cards can we continue to build on that? This is back-door jurisprudence with a vengeance." Loss, *History of S.E.C. Legislative Programs And Suggestions for A Code,* 22 Bus. Law. 795, 796 (1967).

The ramifications of this development are broad, and unforeseen consequences appear to follow inexorably from each successive step, as this litigation tellingly demonstrates. Citing cases such as *SEC* v. *Capital Gains Research Bureau,* 375 U.S. 180 (1963), the Commission persuaded the courts below that the burden of proof should be reduced and that elements essential in private damage suits need not be shown. Thus, new liabilities and new rules of law are announced, ostensibly limited to the enforcement proceeding seeking mild "prophylactic" relief.

Indeed, the present Chief Judge of the Second Circuit, in concurring with the majority below, acknowledged his concern that the new law announced might be applied in private damage actions, stating that the consequences are "frightening" (123a). Yet as the companion petition in *Reynolds* v. *Texas Gulf Surphur Co.* will reveal, the Tenth Circuit followed the decision below in abandoning the basic element of fraud in private damage suits (themselves implied by the courts), and awarded "damages" against Texas Gulf based upon hypothetical profits that might have been made by former Texas Gulf shareholders. Waiting in the wings are numerous private damage actions against Texas Gulf (71a), including a declared class action involving huge potential damages. *Cannon* v. *Texas Gulf Sulphur Co.,* 47 F.R.D. 60 (S.D.N.Y. 1969).

This case is the cornerstone upon which those private damage actions depend, a matter of serious consequences to Texas Gulf's shareholders. But beyond this, the *Texas Gulf Sulphur* case has been the impetus of a flood of lawsuits under Rule 10b-5. With the advent of Fed. R. Civ. P. 23, revised by this Court in 1966, class actions under Rule 10b-5 have multiplied. (*e.g.,* Note, *Impact of Class*

Actions on Rule 10b-5, 38 U. CHI. L. REV. [Winter, 1971].) Not a single such class action has ever gone to judgment after complete trial. *Morris* v. *Burchard,* 51 F.R.D. 530 (S.D.N.Y. 1971). The consequences of a possible adverse verdict are, in Judge Friendly's words, "frightening", indeed too frightening to risk a trial.

We respectfully submit that this Court should for the first time, in the context of this case, review the basic roles of Congress, the Commission and the courts in bringing about these sweeping changes in the law.

II

The holding below, which runs counter to a basic purpose of the securities laws, counter to the expressed intent of Congress and contrary to precedent, presents to this Court fundamental questions of importance under the securities laws concerning corporate and public information practices.

Section 10(b) and Rule 10b-5 were not designed to regulate voluntary corporate publicity. Section 10(b) was enacted by Congress to enable the Commission to deal with newly conceived manipulative devices by purchasers of securities. See, *e.g.,* Testimony of Thomas G. Corcoran, *Hearings on H. R. 7852 and H. R. 8720 before The House Committee on Interstate and Foreign Commerce,* 73d Cong., 2d Sess. 115 (1934). The Commission was authorized to promulgate regulations to prevent manipulative devices of the kind specifically outlawed in Sections 9 and 10(a) of the Act, which, as the dissenting judges below cogently demonstrated, all involved fraudulent activities integ-

rally related to securities transactions (160a). Congress' concern in drafting antifraud provisions in the securities laws, such as Section 17(a) of the 1933 Act and Section 10(b), was not to regulate public statements, but rather to deal with schemes to deceive and defraud the public by means of manipulative and deceptive devices in the purchase or sale of securities (160a-163a). Not only were no facts presented below which could possibly support findings of such a scheme, but in addition the trial court found that "TGS derived [no] direct benefit from the issuance of the press release"; that none of the defendants "who participated in its preparation used it to their personal advantage" (54a); and that the framers "exercised reasonable business judgment under the circumstances" (58a). These factual findings are antithetical to the concept of manipulation or deception.

Rule 10b-5 was promulgated by the Commission to deal with deliberate fraud by purchasers of securities, as the Commission publicly announced.* Within the meaning of

* "The new rule [10b-5] closes a loophole in the protection against fraud administered by the Commission by prohibiting individuals or companies from buying securities if they engage in fraud in their purchase" (SEC Sec. Exch. Act Rel. No. 3230 [May 21, 1942]). The actual draftsman of Rule 10b-5 has related that it was drafted in response to the following situation:

> "* * * the president of some company in Boston, who is going around buying up the stock of his company from his own shareholders at $4.00 a share, and he has been telling them that the company is doing very badly, whereas, in fact, the earnings are going to be quadrupled and will be $2.00 a share for this coming year * * *"

The Rule was drafted and presented to the Commission in one afternoon:

> "* * * We passed a piece of paper around to all the commissioners. All the commissioners read the rule and they tossed it on the table, indicating approval. Nobody said anything except Sumner Pike who said, 'Well,' he said, 'we are against fraud, aren't we?' That is how it happened." Freeman, 22 Bus. Law. 922 (1967).

the Rule a press release could be found to be "in connection with" the purchase or sale of securities only if: (1) the corporation or insiders were in fact trading on the basis of such release; or (2) the purpose of the release was to affect the market price of the company's securities to the advantage of the company or its insiders (51a, 54a). Neither element was shown here.

Moreover, dissemination of information about corporate activities was not left unregulated under the 1934 Act. Section 12 of the 1934 Act requires the registration of securities which are widely held, and detailed information, similar to that required by the 1933 Act, must be filed with the Commission for such securities. This information must be kept "reasonably current" by periodic and other reports filed with the Commission and the stock exchanges. Such disclosure is supplemented by Section 14, regarding proxy regulation, and Section 16 regarding insider purchases and sales. Failure to comply with these provisions, or the making of a false statement in filed reports, is punishable civilly under Section 18 of the Act (where good faith is a defense), or criminally under Section 32 of the Act, requiring intentional wrongdoing. The liabilities imposed under these sections must be balanced (as are similar liabilities imposed in the 1933 Act) against the fact that the requirements for disclosure and the standards of conduct are carefully spelled out. The majority in the Second Circuit found legislative support for its holding below by quoting from the legislative history of Section 18 (compare 106a-107a and 162a) but ignored the fundamental difference that press releases are not required under the 1934 Act and no rules and regulations governing their format have ever been promulgated.

At least one respected commentator has warned against such an expansion of Rule 10b-5 to encompass Section 18 (Milton Cohen, *"Truth in Securities" Revisited,* 79 HARV. L. REV. 1340, 1366, 1370 n. 89 (1966)). It cannot be doubted that the imposition of liability under Rule 10b-5 without requiring a showing of an improper purpose runs counter to a basic policy of the securities laws:

> "But to require them [directors] to guarantee the absolute accuracy of every statement that they are called upon to make, would be to gain nothing in the way of an effective remedy and to fall afoul of the President's injunction that the protection of the public should be achieved with the least possible interference to honest business." H. R. Rep. No. 85, 73d Cong., 1st Sess. 5 (1933).

Further, as cogently pointed out by Judge Friendly, the standards announced by the Second Circuit will result not in more publicity, but in a reluctance of corporations to speak out on matters when not legally required to do so.* The standards announced by the Second Circuit for determining whether or not press releases are misleading impose impossible burdens on business and industry in attempting good faith compliance.

The district judge carefully reviewed the expert testimony concerning the relationship of the facts set forth in the press release to the facts of the drilling known to the responsible Texas Gulf officials and the investment sig-

* "* * * [I]f the only choices open to a corporation are either to remain silent and let false rumors do their work, or to make a communication, not legally required, at the risk that a slip of the pen or failure properly to amass or weigh the facts—all judged in the bright gleam of hindsight—will lead to large judgments, payable in the last analysis by innocent investors, for the benefit of speculators and their lawyers, most corporations would opt for the former" (123a).

nificance of those facts, and concluded that on the basis of objective standards and SEC regulations the press release was not "misleading or deceptive on the basis of the facts then known" (58a).

The Second Circuit reversed this objective standard and enunciated a new test: whether the press release was misleading or not should be determined by the subjective reactions of persons in the market and for this purpose the testimony of dozens of investors taken. But an oath-swearing contest is no method by which to ascertain whether a release is misleading or not. If the only requirement upon the SEC was to show that someone who is *in compos mentis* sold stock on the basis of that release, the whole process is a charade.

To the same end is the Court of Appeals' refusal to give effect to the District Court's finding that Texas Gulf had exercised "reasonable business judgment" in choosing when to issue and how to phrase the press release (58a). Instead the Court of Appeals imposed the *ex post facto* requirement that the "basic facts" be stated in all corporate press releases* (117a). Texas Gulf could have pub-

* The entire thrust of the SEC's enforcement procedures under the 1933 and 1934 Act has heretofore been to prohibit the disclosure of such information until conclusions as to probable or proven ore be drawn. See Item 8A(b), Schedule I to Form 1A relating to Regulation A Offerings under the Securities Act of 1933, quoted in the dissenting opinion of Judge Moore (136a-137a). The decision of the Tenth Circuit in *Sunray DX Oil Co.* v. *Helmerich & Payne, Inc.*, 398 F.2d 447, 451 (10th Cir. 1968), recognized the basic wisdom behind this policy, holding that disclosure of details of oil exploration, "would in the first place make the proxy statement impossibly large and in the second place would be disclosing to the average investor, who has no capacity to judge the scientific significance of the information, material which would not be in the least beneficial in making an enlightened judgment about the proxy solicitation."

lished drill logs but the media obviously would not have printed them in full but more likely in a fashion itself misleading. Here, the Texas Gulf management, containing expert geologists and mining engineers, reviewed the available data and concluded that "the work done to date has not been sufficient to reach definite conclusions and any statement as to size and grade of ore would be premature and possibly misleading." This evaluation was concurred in by eminent experts at the trial. But whether the evaluation was correct or not should hardly be the point; what is important is that the statement was a reasonable and responsible exercise of judgment (*i.e.*, due diligence) by the officials of Texas Gulf, and found to be so by the trier of facts (58a).

III

The imposition of liability for negligent misstatement under Rule 10b-5 upon a well-intentioned company responding to false and exaggerated rumors and commenting on its affairs in the form of a press release presents to this Court an important question of freedom of speech.

The decision below presents the important question of the right of a corporation and its managers, when not motivated by thoughts of gain either to itself or to others, to speak freely on matters of public importance concerning corporate activities, without fear of staggering liabilities in subsequent government or private damage actions. Texas Gulf's April 12 press release was just such a comment on matters of front-page significance; it was not shown to have been issued either with knowledge of falsity,

reckless disregard for truth, or to benefit the corporation, its officers or employees. And yet on the basis of alleged negligent misstatement, Texas Gulf was held to have violated Rule 10b-5, which prohibits fraud, not negligence.

The fundamental freedom of speech and expression should not be denied merely because the subject is a corporate activity. The decision below has affected and will continue to affect every comment responsible corporate managements have made or wish to make on developments, both fortunate and adverse, in their corporations' affairs. These holdings, as Judge Friendly noted, will encourage silence, not the free expression by businessmen of their opinions and judgments on corporate developments, to the detriment of the public, for whose benefit the securities laws were enacted. The fear of repercussions from a slip of the tongue or the pen (or from possible misconstruction of a statement or phrase by one looking for a scapegoat for his losses or missed advantages), will act to chill and impede, if not silence, the free flow of expression and comment.

The Court of Appeals has summarily determined that press releases, words spoken by corporations, are not to be afforded the protection of the First Amendment: "the First Amendment deals with the free exchange of ideas and not with commercial 'factual' speech" (234a), analogizing press releases to prospectuses and registration statements (225a). That analogy fails for at least two reasons: first, the press release was found to have had no commercial motivation (54a), and thus is unlike a registration statement which is designed to elicit funds from the general public at large. Second, under the statutes enacted by Congress, and the rules, regulations and forms

adopted by the Commission, there is a "precision of regulation" of the content of registration statements which is compatible with the First Amendment. Here, of course, no guidelines existed.

This Court, in prior decisions, has expressly refused to stifle freedom of comment if one libelously injured can show no more than that the comment was negligently made. *New York Times* v. *Sullivan,* 376 U.S. 254, 287-288 (1964). This Court there refused to hold that an advertisement placed in the *New York Times* was not entitled to protection simply because the *Times* was paid for it. Yet the court below asserts not only that the comment by Texas Gulf on the rumors is not protected because it was "commercial" (although no economic benefit whatsoever accrued to Texas Gulf) but also that Texas Gulf may be held liable for comments allegedly compiled without "due diligence," even though made in good faith for a laudable purpose.*

The protection of the First Amendment must include comment by businessmen on the natural subject of their comment, *i.e.,* their "commercial" businesses; that Amendment "must embrace *all* issues about which information is needed or appropriate to enable the members of society to cope with the exigencies of their period." (Emphasis supplied). *Thornhill* v. *Alabama,* 310 U.S. 88, 102 (1940). This Court recently, in *Rosenbloom* v. *Metromedia,* 91 S.Ct.

* In attempted justification of this holding the court speculated that "it is almost impossible [for the SEC] to prove that a wrongful purpose motivated the issuance of the misleading statement" and that the necessity of so proving would "handicap unreasonably the Commission in its work." (109a-110a, 111a). But surely rights guaranteed by the Constitution cannot be diluted by claims of governmental expediency.

1811, 1820, n. 12 (1971), with respect to the question of constitutional protection of publication made for gain, expressed "no view on the extent of constitutional protection, if any, for purely commercial communications made in the course of business." To the extent that this case presents the question of the First Amendment rights of a business corporation, it involves the question left open in *Rosenbloom*; however, the expression involved here was not "purely commercial" and thus, we submit, the need for review by this Court is even more necessary.

IV

The Second Circuit adopted a test of materiality in conflict with regulations adopted by the Commission, with decisions of the Seventh and Tenth Circuits, and with its own previous decisions.

The concept of materiality is fundamental to federal securities regulation. The 1933 Act and the 1934 Act require accurate disclosure of material facts in all documents filed pursuant to those acts, and those who misrepresent or conceal material facts in violation of those statutes are subject to heavy penalties and liabilities.

Because of the importance of this concept, the SEC has taken great care in drafting rules defining "materiality" under each of the major acts it administers.* All these

* See, *e.g.*, Rule 12b-2(j) (17 C.F.R. §240.12b-2(j)) under the Securities Exchange Act of 1934; Rule 1-02(g) (17 C.F.R. §210.1-02(g)) of Regulation S-X which governs all financial statements filed under the securities laws; Rule 405 (17 C.F.R. §230.405 (1)) of Regulation C under the 1933 Securities Act; and Rule 8b-2 (17 C.F.R. §270.8b-2) under the Investment Company Act of 1940 (15 U.S.C. §80a-1).

definitions limit material facts to "those matters as to which *an average prudent investor* ought reasonably to be informed." [Emphasis added] In the present case this traditional test of materiality has been abandoned both by the SEC and the Second Circuit, and replaced with a standard under which a fact can be deemed material merely because it "may" affect the desires of "speculators and chartists" as well as other investors to buy, sell or hold securities, or because the fact "might" have some effect on the market price. Obviously, almost any information could fall in such a category, especially with the aid of hindsight. This unworkable and ill-defined application of Rule 10b-5 has created widespread anxiety throughout the corporate and financial communities. The decision below has "set a regrettably low threshold of materiality." (BROMBERG, SECURITIES LAW: FRAUD—SEC Rule 10b-5, Sec. 7.4(3)(c)).

The "standard" created by the Second Circuit, besides conflicting with the SEC rules, also conflicts with earlier judicial elaborations of the "average prudent investor" test. Thus, the Seventh Circuit in *James Blackstone Memorial Library Ass'n.* v. *Gulf, M. & O. R.R.*, 264 F.2d 445, 450-51 (7th Cir.), *cert. denied*, 361 U.S. 815 (1959), held that only "assured" facts, not mere possibilities, were material. Similarly, in *List* v. *Fashion Park, Inc.*, 340 F. 2d 457, 462 (2d Cir.), *cert. denied sub nom., List* v. *Lerner*, 382 U.S. 811 (1965), the Second Circuit held that material facts were those "which in reasonable and objective contemplation might affect the value of the corporation's stock or securities. * * *" It was this precedent which was initially applied by the District Court (25a-26a), but distorted by the Second Circuit in its first decision. Only by such

distortion could the Second Circuit reach the conclusion that the preliminary drilling results were "material"; the combination of findings by the District Court led inescapably to the conclusions that in "reasonable and objective contemplation" one drill core can not be "material" in a company the size of Texas Gulf; one drill core "does not establish an ore body, much less a mine"; with one drill core you can not "even * * * estimate the probabilities that [it] * * * will lead to the discovery of an ore body"; "no predictions could be made as to how far mineral values * * * extended beyond the 1⅛ inch drill core"; "from an investment point of view, no significance could be attached to the results of a single drill core * * *" (29a-30a). But a speculator may be interested in anything.

Again, it was clear that the drilling results as of the time of petitioners' stock purchases or acceptance of stock options did not indicate the existence of "proven" or "probable" ore under the SEC regulations governing disclosure concerning mining exploration quoted in the dissenting opinion below (136a-137a). In *Sunray DX Oil Co.* v. *Helmerich & Payne, Inc.*, 398 F.2d 447 (10th Cir. 1968), the Tenth Circuit held that equivalent regulations were controlling in determining whether facts concerning oil exploration were "material" and, therefore, to be disclosed in proxy material. The decision below is in conflict with that of the Tenth Circuit, as well as with the Commission's own regulations, and should be reviewed by this Court.

V

It is not unlawful for a corporate employee to purchase his company's stock or to accept stock options in the absence of a showing of fraud and deceit.

In this case, for the first time, the courts have imposed a duty upon officers, directors and employees of a public corporation to refrain from purchasing stock of their corporation at a time when they were said to possess "material" information regarding their corporation, which information had not yet been publicly disclosed.

Prior to this action, it seemed clear that, absent actual fraud or deceit, the sole prohibition under the 1934 Act of "insider" purchases was contained in Section 16(b), prohibiting short-swing trading. Section 16(b) is of course aimed at what Congress considered to be abuse of "inside information". The legislative history of that section shows that Congress considered several alternatives to that objective provision and rejected them all. One of the rejected alternatives was a proposal that the court determine in each case whether the officer, director or principal stockholder had made unfair use of inside information. See H. R. Rep. No. 1383, 73d Cong., 2d Sess. 13 (1934); 1934 Senate Hearings at 6557. This subjective standard, consciously rejected by Congress in 1934, is what the courts below resurrected in this lawsuit. The legislative history clearly demonstrates that, absent a showing of fraud or deceit, Section 16(b) was designed to be the sole prohibition against insider trading. See *Hearings on H. R. 7852 and H. R. 8720 before The House Committee on Interstate*

and Foreign Commerce, 73d Cong., 2d Sess. 135 (1934) and *Hearings on H. R. 4344, H. R. 5065 and H. R. 5832 before The House Committee on Interstate and Foreign Commerce,* 77th Cong., 1st Sess. 1255 (1941). Yet it was the legislative history of §16(b) that the Second Circuit utilized to establish the rule specifically rejected by Congress.

Judge Learned Hand observed in 1949 that Congress intended to regulate insider trading "by forbidding 'quick turns' in shares by a director, yet circumscribing his freedom no further." (dissenting opinion) *In re Calton Crescent, Inc.,* 173 F. 2d 944, 952 (2d Cir. 1949), *aff'd sub nom. Manufacturers Trust Co.* v. *Becker,* 338 U.S. 304 (1949). See also *Blau* v. *Max Factor & Co.,* 342 F.2d 304 (9th Cir.), *cert. denied,* 382 U.S. 892 (1965). The Securities and Exchange Commission apparently concurred with Judge Hand's view, as recently as 1957. Petition of SEC as *amicus curiae* for rehearing in *Greene* v. *Dietz,* 247 F.2d 689 (2d Cir. 1957); see CCH Fed. Sec. L. Rep. ¶90,821 at 92,576 (1957).

In the absence of fraud and lack of any manipulative effect, there can be no justification for holding that the broad prohibitions of Section 10(b) and Rule 10b-5 were designed to cover the purchase of stock on a stock exchange by corporate employees. The mere placing by an insider of an order to buy stock on a securities exchange would not cause a seller to rely thereon; there can be neither deception, reliance or causation in such a situation. Moreover, the Second Circuit read out of the statute the requirement of *scienter,* holding that "unreasonable or negligent conduct" was sufficient to establish a violation of Rule 10b-5

(100a). When not some, but *all* the elements of fraud are read out of Rule 10b-5, it can no longer be termed a fraud rule. The interpretation of Rule 10b-5 adopted below cannot be upheld, for a rule of absolute liability is *ultra vires* the Commission's power to proscribe "manipulative or deceptive devices" under Section 10(b). See 3 Loss, SECURITIES REGULATION, p. 1766 (1961).

Similarly, with respect to the acceptance of stock options by Stephens, Fogarty and Kline, the Court of Appeals enunciated new rules of intra-corporate responsibility which have no relation to concepts of fraud and deceit. The grant of options was not induced by petitioners. Indeed, the evidence shows that Kline with his limited knowledge was not even aware that the outside directors had never heard of the first drill hole at Timmins. In imposing liability on these petitioners based on a record which contained no evidence of misrepresentation or breach of duty of disclosure, no *scienter,* and no knowledge of material facts, as previously defined by the Commission and the Courts, the court below totally departed from the language of Rule 10b-5 and created an impossible and unascertainable standard of conduct.

VI

The Court of Appeals completely disregarded Rule 52(a) in (1) reaching geological, geophysical and investment conclusions which were contrary to findings of the trial court and without support in the record and (2) in implicitly overruling Judge Bonsal's finding that Texas Gulf officers had "exercised reasonable business judgment" (*i.e.*, acted with due diligence) in issuing the April 12 release.

The Court of Appeals reached its conclusion that the results of the first hole constituted "material information" by ignoring or overturning findings of fact of the trial judge, based on his appraisal of the testimony of eleven expert witnesses, and his study of numerous exhibits and charts containing geological and geophysical data. The District Court credited expert testimony to the effect that "one drill core does not establish an ore body, much less a mine" and, indeed, that "there is no way even to estimate the probabilities that one drill core will lead to the discovery of an ore body"; that "no predictions could be made as to how far mineral values encountered by [the first drill core] extended beyond the 1⅛ inch drill core", and that "from an investment point of view, no significance could be attached to the results of a single drill hole" (30a). The District Court also found that disclosure of the preliminary drilling results would not have had a substantial impact on the market price of Texas Gulf's 10,000,000 outstanding shares (30a).

The majority of the Court of Appeals did not give the findings of the District Court the consideration and weight

required by law. As pointed out by Chief Judge Lumbard and Judge Moore, dissenting, the majority, in disregard of Fed. R. Civ. P. 52(a), chose "to reject the trial court's finding as to the results of the first drill core, K-55-1, and to substitute their own expertise in the mining engineering field * * *" (135a).*

Thus, the majority stated that from the first hole there was a "possibility which surely was more than marginal of the existence of a mine of * * * vast magnitude * * *" (89a), an interpretation of the geological and geophysical data directly at odds with that of the District Judge and the "virtually uncontradicted testimony" of the experts (135a). Indeed, the court below never referred to the distinguished experts called by defendants and credited by the District Judge, but heavily relied on the deposition of one Michael Roche, a Canadian penny stock speculator, to support its geological and investment conclusions (90a). The procedures followed below conflict with basic principles of appellate jurisdiction repeatedly stated by this Court (see, *e.g., Graver Tank & Mfg. Co. Inc.* v. *Linde Air Prods. Co.*, 339 U.S. 605-10 (1950)) and should be corrected.

Furthermore, the Court of Appeals ignored or misunderstood Judge Bonsal's finding that under all the circumstances Texas Gulf's officials had acted with due diligence in drafting and issuing the release (57a-58a). Apparently because Judge Bonsal used the phrase "reasonable busi-

* With respect to the press release, the Court of Appeals ignored the findings of the District Court based on the testimony of defendants' experts that Kidd 55 was still a prospect, that "no estimates as to proven or probable ore could be made", and "that the April 12 press release accurately set forth the situation as it was known at the time" (56a). It indicated its belief that, despite these findings, the press release was probably misleading (114a).

ness judgment under the circumstances" rather than "due diligence", the Court of Appeals concluded that he had not passed on the point and the appellate court included the question of due diligence in its remand. However, the majority opinion indicated so strongly the view of the majority of the circuit judges that due diligence had not been exercised that Judge Bonsal felt constrained to bow to what he regarded as the command of the appellate court rather than to reassert his own conclusion (186a, 188a).

VII

The decisions of the courts below violate petitioners' constitutional rights under the Fifth Amendment and well-settled principles of administrative procedure.

The Fifth Amendment requires that:

> "* * * a fair warning should be given to the world in language that the common world will understand, of what the law intends to do if a certain line is passed. To make the warning fair, so far as possible, the line should be clear." *McBoyle* v. *United States*, 283 U.S. 25, 27 (1931) (Holmes, J.).

A finding of violation of a statute "ought not to rest upon an interpretation reached by the use of policy judgments rather than by the inexorable command of relevant language." *M. Kraus & Bros., Inc.* v. *United States*, 327 U.S. 614, 626 (1946). In *Kraus* it was held that an administrative body must frame its rules so "that the ordinary person can know in advance how to avoid an unlawful course of action." *Id.* at 622. See also *Boyce Motor Lines, Inc.* v. *United States*, 342 U.S. 337 (1952). Rule 10b-5 certainly

gave no warning to petitioners that their conduct in issuing a press release or in purchasing their company's stock, or accepting stock options could be held in violation of a statute and rule prohibiting manipulative or deceptive devices. The publicity generated by this case proves that no fair warning was given.

If it is assumed, *arguendo,* that the Commission had authority to propose regulations covering the law made in this case, public comment and hearing as required by the Administrative Procedure Act would have afforded deliberative weighing of the social and economic consequences of the regulations. But rather than promulgate a rule which would operate prospectively, respondent has instead persuaded the Court of Appeals, in this case of first impression, to hold petitioners' various conduct to be employments "of a manipulative or deceptive device or contrivance."

The Court of Appeals' opinions are the unfortunate result of the exigencies of litigation rather than the product of the regulatory process entrusted to the SEC by Congress. It is important that this Court consider the statutory and constitutional limitations upon respondent's powers and the unfair procedures whereby the statute and rule have been extended, without prior notice and without regard to proper legislative and administrative procedures, far beyond their language and purpose. *Cf. Blau* v. *Lehman,* 368 U.S. 403 (1962).

VIII

Whether the SEC, in an enforcement proceeding under Section 21(e) of the 1934 Act, may seek a remedy which requires a stock option to be rescinded, is an issue as yet undecided by this Court and as to which a conflict exists between the Second and Ninth Circuits.

As to petitioner Kline the court below remanded to the District Court, which has held Kline liable for the difference between the option price and the price of Texas Gulf stock on April 17, 1964. This holding, together with the holding by the court below that in an enforcement proceeding under Section 21(e) of the 1934 Act the SEC may seek not only injunctive relief but also restitution and rescission (228a) presents a legal issue which may be considered along with the similar issue raised by other petitioners.*

The court below reached its conclusion that such remedies may be sought even in the light of express statutory language to the contrary; Section 21(e) states that the SEC may "bring an action * * * to enjoin such acts or practices [which constitute or will constitute a violation of the provisions of this title, or of any rule or regulation thereunder]". The court held that Section 27 of the 1934 Act, which is a general grant of jurisdiction to the District Courts, is authority for the proposition that the SEC may seek in an enforcement proceeding remedies equivalent to damages or penalties. With this conclusion the Court of Appeals for the Ninth Circuit, construing similar provi-

* See the companion petitions of Crawford, Huntington, Clayton, Holyk and Darke.

sions, has disagreed. *United States* v. *Parkinson,* 240 F. 2d 918 (1956). The wisdom of the rationale of that decision is plain in the context of this proceeding, and the conflict between the Circuits becomes an important question for this Court to decide. The SEC, by bringing this action as an enforcement proceeding under Section 21(e), has obtained decisions by which it may extract not only from petitioners but also from future defendants substantial sums, utilizing a lesser quantum of proof than would be necessary for it to establish a violation under Section 32 with its criminal sanctions.

On this issue this Court has expressly reserved opinion in a previous decision. *SEC* v. *National Securities, Inc.,* 393 U.S. 453, 462, n. 5 (1969).

IX

The Court below erroneously denied to petitioners an opportunity for oral argument of the issues before a quorum of the Court sitting *en banc*.

The court below rendered its *en banc* decision in 1968 without affording petitioners an opportunity for oral argument before a quorum of the active judges of the circuit. The need for review of this practice is developed in the companion petition of David Crawford and need not be repeated here.

Conclusion

For the foregoing reasons, this petition for a writ of certiorari should be granted.

Respectfully submitted,

ORISON S. MARDEN
Attorney for Petitioners
Texas Gulf Sulphur Company,
Fogarty, Mollison, Stephens and Kline

P. B. KONRAD KNAKE
THOMAS MCGANNEY
JEFFREY A. BARIST
W. NEIL THOMAS, III
WHITE & CASE
Of Counsel

September 3, 1971

ADDENDUM

Indicative of the importance of the issues presented by this petition and companion petitions is the number of texts devoted either entirely or in part to it. Among the most noteworthy of these are:

A. Bromberg, Securities Law: Fraud—SEC Rule 10b-5 (1969): ("The filing of the Texas Gulf Sulphur suit gave us all a jolt"); ("celebrated case").

A. Fleischer, Jr. & J. Flom, Texas Gulf Sulphur—Insider Disclosure Problems (PLI 1968); ("One of the most troublesome decisions in recent years in the corporate field"—E. Donald Shapiro, PLI Director).

J. Flom, B. Garfinkel & J. Freund, Disclosure Requirements of Public Companies and Insiders (PLI 1967).

H. Manne, Insider Trading and the Stock Market (1966).

W. Painter, Federal Regulation of Insider Trading (1968): ("The rumblings first heard in the *Cady, Roberts & Co.* case * * * have attained earthquake proportions with the * * * announcement by the Second Circuit Court of Appeals of its *en banc* decision in *SEC* v. *Texas Gulf Sulphur Co.*").

Over one hundred law review articles, comments and notes have been published on this case, its impact on the financial community, and the novel questions it raises. The following are illustrative.

Bradford, "*Rule 10b-5: The Search for a Limiting Doctrine.*" 19 Buffalo Law Review 205 (1970).

Bromberg, *Corporate Information: Texas Gulf Sulphur and Its Implications,* 22 Sw. L. J. 731 (1968); ("landmark decision"); ("*TGS* takes antifraud securities law significantly farther along the paths traced in recent years").

Bromberg, *Disclosure Programs for Publicly Held Companies—A Practical Guide,* 1970 Duke L. J. 1139; ("historic decision").

Delancey, *Rule 10b-5—A Recent Profile,* 25 Bus. Law. 1355 (1970); ("*Texas Gulf* * * * operates to compound rather than to contain the problem.").

Fleischer, *Securities Trading and Corporate Information Practices: The Implications of the Texas Gulf Sulphur Proceeding,* 51 Va. L. Rev. 1271 (1965); ("generated an unprecedented amount of comment").

Harfield, *Texas Gulf Sulphur and Bank Internal Procedures Between the Trust and Commercial Departments,* 86 Banking L. J. 869 (1969); (a landmark but not a guidepost).

Jennings, *Insider Trading in Corporate Securities: A Survey of Hazards and Disclosure Obligations Under Rule 10b-5,* 62 Nw. U. L. Rev. 809 (1968).

Kennedy & Wander, *Texas Gulf Sulphur, A Most Unusual Case,* 20 Bus. Law. 1057 (1965); ("the beginning of what could be a revolutionary change in [SEC] practice").

Knauss, *Disclosure Requirements—Changing Concepts of Liability,* 24 Bus. Law. 43 (1968).

Leavell, *The Texas Gulf Sulphur Opinion in the Appellate Court: An Open Door to Federal Control of Corporations,* 3 U. Ga. L. Rev. 141 (1968).

Manne, *Insider Trading and the Administrative Process,* 35 GEO. W. L. REV. 473 (1967). ("In *SEC* v. *Texas Gulf Sulphur Co.,* the development [of a federal law on insider trading] is certainly nearing some sort of pinnacle"); ("famous case"); ("A great many legal questions at issue").

Marsh, *What Lies Ahead Under Rule 10b-5?,* 24 BUS. LAW. 69, 73 (November 1968). ("What lies ahead under Rule 10b-5 * * * Chaos!)

Osborn, *Texas Gulf Sulphur: A Vigorous Assault on Insider Trading and Misleading Press Releases,* 11 ARIZ. L. REV. 290 (1969); ("a decision significant both for its far-reaching impact on the state of the law as it then existed and for the serious questions which it raises").

Painter, *Inside Information: Growing Pains for the Development of Federal Corporation Law Under Rule 10b-5,* 65 COLUM. L. REV. 1361 (1965); (raising novel questions); (spectacular nation-wide publicity).

Posner, *Developments in Federal Securities Regulation,* 22 BUS. LAW. 645 (1967).

Posner, *Developments in Federal Securities Regulation,* 21 BUS. LAW. 703 (1966).

Ruder, *Texas Gulf Sulphur—The Second Round: Privity and State of Mind in Rule 10b-5 Purchase and Sale Cases,* 63 NW. U. L. REV. 423 (1968). (A case raising "serious questions regarding the extent to which liability should be imposed for violation of * * * Rule 10b-5").

Whitney, *Section 10b-5: From Cady, Roberts to Texas Gulf: Matters of Disclosure,* 21 BUS. LAW. 193, 194 (1965). ("source of concern, not to say frustration, to corporate management and counsel").

Wiesen, *Disclosure of Inside Information—Materiality and Texas Gulf Sulphur,* 28 MD. L. REV. 189 (1968).

Wu, *An Economist Looks at Section 16 of the Securities Exchange Act of 1934*, 68 COLUM. L. REV. 260 (1968); ("*SEC* v. *Texas Gulf Sulphur Company* has stimulated great interest in and out of the legal profession").

Note, *SEC* v. *Texas Gulf Sulphur Co.: The Inside and Outside of Rule 10b-5*, 46 BOSTON U. L. REV. 205 (1966); ("an excellent opportunity for the federal judiciary to provide clear guidelines which have to date been lacking under Rule 10b-5").

Note, *Corporate Recovery for Insider Violations*, 36 BROOKLYN L. REV. 78 (1969); ("landmark opinion").

Note, *Insider Disclosure—A Conflict Between Section 5(c) and Rule 10b-5*, 37 BROOKLYN L. REV. 123 (1970); ("leading case").

Symposium—*Insider Trading in Stocks*, 21 BUS. LAW. 1009 (1966).

Note, *Scienter and Rule 10b-5*, 69 COLUM. L. REV. 1057 (1969); ("Few decisions have had as much impact on the securities market").

Note, *A Suggested Locus of Recovery in National Exchange Violations of Rule 10b-5*, 54 CORNELL L. REV. 306 (1969): (may result in "judicial and administrative chaos").

Note, *Scienter in Private Damage Actions Under Rule 10b-5*, 57 GEO. L. J. 1108 (1969); ("landmark case").

Note, 82 HARV. L. REV. 938 (1969).

Note, *Rule 10b-5: The Effect of the Insider Trading Decisions on the Security Analyst*, 54 MINN. L. REV. 147 (1969); ("major case of the decade").

Note, *Impact of Class Actions on Rule 10b-5*, 38 U. CH. L. REV. (Winter, 1971).

Note, *The Corporation's Obligations of Disclosure Under the Federal Securities Laws When It Is Not Trading in Its Stock,* 15 N.Y.L.F. 385 (1969); ("development of great importance").

Note, *Texas Gulf Sulphur: Expanding Concepts of Corporate Disclosure Under SEC Rule 10b-5,* 43 ST. JOHN'S L. REV. 425, 655 (1969) (two parts); ("landmark opinion") ("historical decision"); ("so far-reaching in its possible applications that the final disposition of the relevant issues could directly affect the operating procedures of virtually all phases of our nation's vast securities industry"); ("monumental impact").

Comment, 16 UCLA L. REV. 404 (1969).

Note, *Texas Gulf Sulphur: Its Holdings and Implications,* 22 VAND. L. REV. 359 (1969); ("seldom has any development been met with such a reaction by the financial press").

Editorial, *The Wall Street Journal* (August 31, 1968); ("REGULATION CARRIED TO ABSURDITY").

Editorial, *The Wall Street Journal* (August 21, 1968); ("The potential impact of the Federal Circuit Court's ruling, however, is tremendous. * * * Common sense obviously is not served by a court decision that seems written to foster indecision and confusion.")

LIBRARY
SUPREME COURT, U. S.

Supreme Court, U.S.
FILED
NOV 16 1971
E. ROBERT SEAVER, CLERK

Nos. 71-327, -328, -346, -347

In the Supreme Court of the United States

OCTOBER TERM, 1971

TEXAS GULF SULPHUR COMPANY, ET AL., PETITIONERS
v.
SECURITIES AND EXCHANGE COMMISSION

EARL L. HUNTINGTON, PETITIONER
v.
SECURITIES AND EXCHANGE COMMISSION

DAVID M. CRAWFORD, PETITIONER
v.
SECURITIES AND EXCHANGE COMMISSION

WALTER HOLYK, ET AL., PETITIONERS
v.
SECURITIES AND EXCHANGE COMMISSION

ON PETITIONS FOR WRITS OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF OF THE SECURITIES AND EXCHANGE COMMISSION IN OPPOSITION

ERWIN N. GRISWOLD,
Solicitor General,
Department of Justice,
Washington, D.C. 20530.

G. BRADFORD COOK,
General Counsel,
DAVID FERBER,
Solicitor,
FRANK E. KENNAMER, Jr.,
Assistant General Counsel,
HARVEY L. PITT,
Special Counsel,
STUART A. MORSE,
Attorney,
Securities and Exchange Commission,
Washington, D.C. 20549.

INDEX

	Page
Opinions below	1
Jurisdiction	2
Questions presented	2
Statute and rule involved	4
Statement	4
1. The Commission's complaint	6
2. The evidence relevant to petitioners	7
3. The judicial decisions:	
A. The initial decisions of the district court and the court of appeals: The violations	14
Insiders purchasing Texas Gulf stock and "tipping" others to purchase	15
Insiders' acceptance of stock options	17
Texas Gulf's April 12, 1964, press release	18
B. The subsequent decisions of the district court and the court of appeals: The appropriate remedy:	
The individual defendants	21
Texas Gulf's April 12, 1964, press release	23
Argument	25
Conclusion	49